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NAVY FINANCIAL REPORTING OF  
GOVERNMENT-OWNED MATERIALS HELD BY  
COMMERCIAL SHIPYARD CONTRACTORS

Report No. D-2001-071

March 2, 2001

Office of the Inspector General  
Department of Defense

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<b>Abstract</b> We performed this audit in support of the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994. In March 2000, the Under Secretary of Defense (Comptroller) requested that the Defense Contract Audit Agency (DCAA) conduct an audit to validate the value of Government-owned property held by contractors. DCAA agreed to assist the DoD Inspector General in examining the processes and requirements for reporting operating materials and supplies. DCAA will report on the Government-owned property held by contractors based on a review of 36 contractors throughout DoD. The FY 1999 Navy financial statements reported \$29.3 billion of operating materials and supplies, which included \$11.3 billion of Government-owned materials held by contractors. Government-owned materials are materials furnished by the Government that are intended to be incorporated in, or attached to, a deliverable end item or materials consumed in the performance of the contract.		
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### **Acronyms**

CPMS	Contract Property Management System
DCAA	Defense Contract Audit Agency
DFARS	Defense Federal Acquisition Regulation Supplement
FAR	Federal Acquisition Regulation
NDPPE	National Defense Property, Plant, and Equipment
OM&S	Operating Materials and Supplies
SFFAS	Statement of Federal Financial Accounting Standards
SUPSHIP	Supervisor of Shipbuilding, Conversion and Repair
USD(C)	Under Secretary of Defense (Comptroller)



INSPECTOR GENERAL  
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March 2, 2001

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (ACQUISITION,  
TECHNOLOGY AND LOGISTICS)  
UNDER SECRETARY OF DEFENSE (COMPTROLLER)  
DIRECTOR, DEFENSE PROCUREMENT  
NAVAL INSPECTOR GENERAL

SUBJECT: Audit Report on Navy Financial Reporting of Government-Owned  
Materials Held by Commercial Shipyard Contractors  
(Report No. D-2001-071)

We are providing this report for review and comment. We performed the audit to support the requirements of the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. We considered comments from the Under Secretary of Defense (Comptroller) and the Under Secretary of Defense (Acquisition, Technology and Logistics) when preparing the final report. The Commander, Naval Sea Systems Command did not respond to the draft report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. As a result of management comments, we revised and renumbered the recommendations. We request the Under Secretary of Defense (Comptroller) comment on Recommendation 1. and the Commander, Naval Sea Systems Command, comment on Recommendations 3.a. and 3.b. by April 30, 2001.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Charles J. Richardson at (703) 604-9582 (DSN 664-9582) (crichardson@dodig.osd.mil) or Mr. Ronald W. Hodges at (703) 604-9592 (DSN 664-9592) (rhodges@dodig.osd.mil). See Appendix E for the report distribution. The list of audit team members is located on the inside back cover.

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Acting Assistant Inspector General  
for Auditing

## Office of the Inspector General, DoD

**Report No. D-2001-071**

(Project No. D2000FA-0094)

**March 2, 2001**

### **Navy Financial Reporting of Government-Owned Materials Held by Commercial Shipyard Contractors**

#### **Executive Summary**

**Introduction.** We performed this audit in support of the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994. In March 2000, the Under Secretary of Defense (Comptroller) requested that the Defense Contract Audit Agency (DCAA) conduct an audit to validate the value of Government-owned property held by contractors. DCAA agreed to assist the DoD Inspector General in examining the processes and requirements for reporting operating materials and supplies. DCAA will report on the Government-owned property held by contractors based on a review of 36 contractors throughout DoD.

The FY 1999 Navy financial statements reported \$29.3 billion of operating materials and supplies, which included \$11.3 billion of Government-owned materials held by contractors. Government-owned materials are materials furnished by the Government that are intended to be incorporated in, or attached to, a deliverable end item or materials consumed in the performance of the contract.

**Objectives.** The audit objective was to determine whether DoD property in the possession of contractors is properly reported in the account balances for DoD financial statements or required supplementary stewardship information. Specifically, we focused on whether the Navy accurately reported operating materials and supplies held by five commercial shipyard contractors. We did not review the management control program as it related to the overall objectives because DCAA evaluated internal controls at the five commercial shipyards.

**Results.** The Navy reported the value of Government-owned materials held by contractors using the Contract Property Management System database, which did not provide complete or accurate financial data that met the requirements of Federal accounting standards. Furthermore, the Navy overstated the value of \$4.3 billion of Government-owned materials reviewed at five commercial shipyards by at least \$1.4 billion for FY 1999. As a result, the Navy disclaimed the appropriateness of the balance on its financial statements for FY 1999. For FY 2000, the Navy is not reporting any values for Government-owned materials held by contractors on its financial statements. Until corrected, the Navy will continue to report incomplete and inaccurate financial data in FY 2001 and beyond. For details of the audit results, see the Finding section of the report.

**Summary of Recommendations.** We recommend that the Under Secretary of Defense (Comptroller) revise the DoD Financial Management Regulation, DoD 7000.14-R to require Government-owned materials held by contractors to be reported as assets in the financial statements and as acquisitions-in-process in accordance with Statement of

Federal Financial Accounting Standards. We also recommend that the Director, Defense Procurement, revise the Defense Federal Acquisition Regulation Supplement after the updated DoD property accountability procedures are agreed upon. We recommend that the Commander, Naval Sea Systems Command, provide accurate pricing data on Government-owned materials furnished from the Navy to the contractors and continue developing financial accounting feeder systems so values reported on the financial statements can be relied upon.

**Management Comments.** The Deputy Chief Financial Officer nonconcurred with the recommendation and disagreed with our interpretation of Statement of Federal Financial Accounting Standard No. 3. The Deputy stated that commercial shipyard contractors are end users and that material held by contractors should be expensed and not reported as an asset on the financial statements. The Director, Defense Procurement, concurred with the intent of the recommendation on revising the Defense Federal Acquisition Regulation Supplement. The Director stated that the Under Secretary of Defense (Acquisition, Technology, and Logistics), in coordination with the Under Secretary of Defense (Comptroller); Office of the Inspector General, DoD; and the General Accounting Office, is developing new property accountability procedures to improve financial reporting of Government-owned materials. The Director offered to revise the Defense Federal Acquisition Regulation Supplement as soon as the new property accountability procedures are agreed upon. The Commander, Naval Sea Systems Command, did not provide comments. See the Finding section for a discussion of the management comments and the Management Comments section for a complete text of the management comments.

**Audit Response.** We disagree with the Deputy Chief Financial Officer's assertion that Government-owned materials held by commercial shipyard contractors should be expensed and not reported as assets in the financial statements. The Deputy's position is inconsistent with the Statement of Federal Financial Accounting Standard No. 3. The Statement of Federal Financial Accounting Standard No. 3 specifically states that contractors that hold materials for future use are not end users. However, we revised the recommendation to clarify that Government-owned material held by contractors should be accounted for as an asset in the financial statements and expensed in an acquisition-in-process account when issued by the contractor in the manufacturing of Navy ships. The Director, Defense Procurement, comments were responsive. The Director agreed to revise the Defense Federal Acquisition Regulation Supplement after the new property accountability procedures are agreed upon. We changed the recommendation to reflect this sequence of events. We also deleted the recommendations that require contractors to report the value of Government-owned materials in the Contract Property Management System database by categories because the Director agreed to revise the Defense Federal Acquisition Regulation Supplement. We request the Under Secretary of Defense (Comptroller) and the Commander, Naval Sea Systems Command, provide comments to the final report by April 30, 2001.

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## Background

The Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356), requires DoD to submit annual, audited financial statements to the Director, Office of Management and Budget. Additionally, the DoD Financial Management Regulation (DoD 7000.14-R) and the Statement of Federal Financial Accounting Standards (SFFAS) provide guidance for preparing the financial statements. The combined requirements of the public laws, regulations, and standards provide guidance for reporting Government-owned materials held by contractors as part of operating materials and supplies (OM&S) on the DoD financial statements. A description of the SFFAS and the DoD 7000.14-R as they apply to OM&S is in Appendix C.

**Federal Acquisition Regulation Part 45.** The Federal Acquisition Regulation (FAR) part 45, “Government Property,” provides guidance to contractors for reporting Government-owned property in the contractors’ possession. The Defense Federal Acquisition Regulation Supplement (DFARS) part 245, “Government Property,” provides more specific guidance for contractors performing work for the DoD. The FAR part 45 defines Government-owned property in the custody of contractors as property owned or acquired by the Government under the terms of the contract. In this report, we focus on materials, which are included in the definition of Government-owned property whether furnished to contractors by the Government or acquired by contractors for the Government.

**Annual Reporting of Government-Owned Property.** Defense contractors annually report the amount of Government-owned property in their possession on the DD Form 1662, “DoD Property in the Custody of Contractors,” March 1989. The FAR part 45 requires contractors to report the dollar value of each category of property on the DD Form 1662. DoD property administrators review the DD Form 1662 and enter the Government-owned property data from the DD Form 1662 into the Contract Property Management System (CPMS). The CPMS is a DoD system that provides an annual snapshot of Government-owned property balances as of September 30 to give Congress an annual overview of Government-owned property; however, the CPMS was not designed for reporting financial data.

During our audit, the Under Secretary of Defense (Comptroller) (USD [C]) requested the Defense Contract Audit Agency (DCAA) to assess the classification and valuation of Government-owned property held by contractors. DCAA performed the evaluation at 36 contractor locations and provided results to the USD(C) in September 2000.

## Objectives

The audit objective was to determine whether DoD property in the possession of contractors is properly reported in the account balances for DoD financial

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statements or required supplementary stewardship information. Specifically, we focused on whether the Navy accurately reported the operating materials and supplies held by five commercial shipyard contractors. We did not review the management control program because DCAA was to evaluate internal controls at the shipyards. See Appendix A for a discussion of the audit scope and methodology and Appendix B for prior coverage.

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## **Government-Owned Materials Held by Contractors**

The Navy reported the value of Government-owned materials held by contractors on its financial statements for FY 1999 using the CPMS database, which did not provide complete or accurate financial data. The CPMS data were incomplete and inaccurate because:

- the DFARS does not require contractors to report the value of Government-owned materials held by contractors in a manner that meets Federal and DoD financial statement reporting requirements;
- the Navy did not provide the value or adequate supporting documentation for at least 2,157 items and overstated at least \$1.4 billion of Government-owned materials furnished to the contractors; and
- the contractors did not report at least \$2.2 million of costs associated with materials acquired and fabricated for the Government.

As a result, the Navy overstated the value of \$4.3 billion of Government-owned materials reviewed at five commercial shipyards by at least \$1.4 billion in its financial statements for FY 1999. Also, for FY 2000, the Navy is not reporting any values for Government-owned materials held by contractors on its financial statements because CPMS is not reliable and the Navy has no other source for this data. Therefore, the Navy will continue to report incomplete and inaccurate financial data on financial statements for FY 2001 and beyond if the CPMS database is not corrected.

## **Navy Reporting of Government-Owned Materials Held by Contractors**

The Navy reported the value of Government-owned materials held by contractors using the CPMS database. In FY 1999, the Navy reported \$29.3 billion in total OM&S,<sup>1</sup> of which \$11.3 billion was Government-owned materials held by contractors. Of the \$11.3 billion, we reviewed \$4.3 billion of Government-owned materials held by five commercial shipyards. We determined that the CPMS database did not provide accurate or complete financial information that met the requirements of SFFAS No. 3, "Accounting for Inventory and Related Property," October 27, 1993.

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<sup>1</sup>Total Operating Materials and Supplies consists of the following categories: ammunition, sponsor-owned material, Government-furnished materials, contractor-acquired material, secondary end items, and other.

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## Completeness of Contractor Guidance

The FAR part 45 and DFARS part 245 require DoD contractors to keep official records for Government-owned property held by the contractors. However, the FAR and DFARS do not require contractors to report the value of Government-owned materials held by contractors in a manner that meets Federal and DoD financial statement reporting requirements. Therefore, the commercial shipyard contractors did not identify and report Government-owned materials by categories similar to those established by the SFFAS No. 3 or separately report on-hand materials and work-in-process balances in accordance with the SFFAS No. 3 and SFFAS No. 8, “Supplementary Stewardship Reporting,” September 30, 1997.

**Categorizing of Government-Owned Materials.** The CPMS database provided incomplete financial data because the DFARS does not require contractors to identify and record Government-owned materials held by required categories. The SFFAS No. 3, paragraph 37, requires that materials be reported on the financial statements by the following categories: (1) held for use; (2) held in reserve for future use; or (3) excess, obsolete, and unserviceable. Because contractors were not required to report Government-owned materials in accordance with financial requirements, we were unable to determine the value of materials held by contractors by specific category. However, we performed a limited review of Government-owned materials based on receiving dates listed on shipping documents and contractor databases. We determined that Government-owned materials may be held in warehouses for as long as 4 years. Contractors stated that the dates received are not always updated and items were not necessarily used from the inventory on a first-in, first-out basis. Unless the DFARS is revised to require that Government-owned materials held by contractors be reported by categories similar to those established by the SFFAS No. 3, DoD will not be able to comply with Federal financial reporting standards.

**Reporting Government-Owned Materials On Hand and Work In Process.** The CPMS provided incomplete financial data because the DFARS did not require contractors to identify and separately record on-hand materials and work-in-process balances for Government-owned materials. The SFFAS Nos. 3 and 8 require Government-owned materials used in construction of National Defense Property, Plant and Equipment (NDPPE)<sup>2</sup> to be expensed when incorporated into the end item. As a result, materials that have been issued for construction must be reported in a work-in-process account, separate from material that is on hand.

Even though the five commercial shipyard contractors were not required to report Government-owned materials issued to a work-in-process account

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<sup>2</sup>SFFAS No. 11, “Amendments to Accounting for Property, Plant, and Equipment,” October 1998, amended SFFAS No. 8 by eliminating the category of Federal mission PP&E and creating a new category for national defense PP&E.

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separate from materials on hand, we identified about \$31 million of Government-owned materials that should have been reported as work in process at two of the five shipyards. For example, one contractor identified at least \$27 million of the \$343.5 million of Government-owned materials that should have been reported as work in process for three contracts reported in the CPMS database. We also determined that \$3.9 million of the \$83.8 million of Government-owned materials reported in CPMS by another contractor should have been reported as work in process. See the table on page 6 and Appendix D for details from each shipyard.

## **Accuracy of Values Provided by the Navy**

The Naval Sea Systems Command is the contract administrator and property administrator for Navy contracts with commercial shipyards. The Naval Sea Systems Command did not provide accurate values or adequate supporting documentation for Government-owned materials furnished to the contractors and reported in the CPMS database.

The CPMS database provided financial information that was inaccurate because values for Government-owned materials furnished by the Navy to the contractors were unreliable. The values were unreliable because the Navy did not provide contractors with individual prices for substantial quantities of Government-owned materials. Of 5,799 Government-owned material items furnished to the contractors by the Navy at three of the five commercial shipyards, the contractors did not have prices on supporting documents for 2,157 items (37 percent). Contractors reported zero value for Government-owned materials when unable to obtain price information from the Navy or develop reasonable estimates.

The values of the Government-owned materials furnished to the contractors were also unreliable because the contractors reported total system prices provided by the Navy in CPMS even if component items of the systems had not been received. For example, the contractor at the Supervisor of Shipbuilding, Conversion and Repair, Pascagoula, Mississippi, reported a total of \$1.5 billion for Government-owned materials furnished by the Navy. Based on supporting documentation, we determined the value of Government-owned materials furnished by the Navy was only \$163 million. Inaccurate pricing at two other shipyards resulted in overstatements of approximately \$63.7 million. By reporting the Government-owned materials at the system prices or at zero value in the CPMS database, the commercial shipyard contractors overstated Government-owned materials by approximately \$1.4 billion and understated 2,157 items of Government-owned materials by an undetermined value. See the table on page 6 and Appendix D for details from each shipyard.

## Accuracy of Values Provided by the Contractors

The contractors did not include all costs associated with materials acquired and fabricated for the Government when reporting the value of Government-owned materials in the CPMS database.

The CPMS database provided financial information that was inaccurate because the value of materials acquired by the contractor for the Government did not include the full cost that the Government paid for the materials. SFFAS No. 3 requires Government-owned materials to be reported at historical cost, which would include all costs (for example, labor and overhead) incurred by the contractor to acquire or fabricate the materials it provides to the Government.

At the five commercial shipyards, the contractors did not report in CPMS the full costs of the materials the contractors acquired or fabricated for the Navy, which resulted in understatements totaling at least \$21.9 million. See the table below for details from each shipyard.

<b>Overstatement of Government-Owned Materials Reported In FY 1999 Navy Financial Statements</b> (in thousands)			
Commercial Shipyard	Not Reported As Work In Process	Improper Value Provided By:	
		<u>Navy</u>	<u>Contractors</u>
Shipyard 1	UND	\$1,369,914 (O)	\$ 32 (U)
Shipyard 2	\$27,000 (O)	4,500 (O)	UND
Shipyard 3	3,918 (O)	59,174 (O)	2,700 (U)
Shipyard 4	UND	UND	104 (U)
Shipyard 5	UND	UND	19,029 (U)
Total	\$30,918	\$1,433,588	\$21,865
<b>Net Overstatement of Government-Owned Materials</b>			<b>\$1,442,641</b>
O = Overstated			
U = Understated			
UND = Undeterminable			

Of the \$4.3 billion of Government-owned materials reviewed at five commercial shipyards, approximately \$1.4 billion, or 33 percent,<sup>3</sup> was overstated on the FY 1999 Navy financial statements. In the FY 2000 financial statements, the Navy is not reporting any value for Government-owned materials held by contractors.

<sup>3</sup>The 33 percent only applies to the five shipyards visited during the audit.

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## Disclosure of Government-Owned Materials Held by Contractors

The FY 1999 Navy financial statements reported \$29.3 billion in OM&S, including \$11.3 billion for Government-owned materials held by contractors, but also disclosed that the data contained material financial reporting limitations. Footnote 1A, “Significant Accounting Policies: Basis of Presentation,” of the Navy financial statements states that the Navy:

...is unable to implement all elements of the SFFAS due to limitations of its financial management processes and systems, including nonfinancial feeder systems and processes. Reported values and information for the [Navy’s] major asset and liability categories are derived from nonfinancial feeder systems, such as inventory systems and logistic systems [including CPMS]. These systems are designed to support reporting requirements focusing on maintaining accountability over assets and reporting the status of federal appropriations, and not the current emphasis of business-like financial management reporting. As a result, the [Navy] can not currently implement all elements of SFFAS. However, the [Navy] continues to implement process and system improvements addressing the limitations of its financial and nonfinancial feeder systems.

Also, Footnote 8B, “Operating Materials and Supplies (OM&S), Net,” of the FY 1999 Navy financial statements states the following:

The consumption method of accounting for the recognition of expenses has been applied to OM&S. However, current financial and logistics systems can not fully support the consumption method....During FY 2000, the [Navy] along with the DoD will examine the process and requirements for reporting this material.

However, based on DoD 7000.14-R, volume 6B, chapter 4, October 2000, the Navy did not report any value for Government-owned material held by contractors in its FY 2000 financial statements and Footnote 9B, “Operating Materials and Supplies (OM&S), Net,” states:

Government Furnished Material (GFM) and Contractor Acquired Material (CAM) [Government-owned Material held by contractors]. The value of the [Reporting Entity’s] GFM and CAM in the hands of the contractors is generally not included in the OM&S values reported above. The DoD is presently reviewing its process for reporting these amounts in an effort to determine the appropriate accounting treatment and the best method to annually collect and report required information without duplicating information already in other existing logistics systems.

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## Navy and DoD Actions

In FY 2000, USD(C), DCAA, and the Assistant Secretary of the Navy (Research, Development, and Acquisition) examined the processes and requirements for reporting Government-owned materials held by contractors.

**Navy Actions.** In FY 2000, the Navy had an OM&S working group review its accounting practices for Government-owned property. The OM&S working group recommended moving data onto the Defense Property Accountability System and developing a financial accounting feeder system that will capture data the Navy needs to accurately report Government-owned property on its financial statements. In addition, the Navy stated that it will follow USD(C) changes to DoD 7000.14-R by not using CPMS data and not reporting any value for Government-owned materials held by contractors on its FY 2000 financial statements.

**Under Secretary of Defense (Comptroller) Actions.** In FY 2000, USD(C) requested that DCAA review Government-owned property held by contractors reported in the CPMS database for FY 1999 and proposed changes to DoD 7000.14-R for FY 2000 financial statement reporting of OM&S.

USD(C) requested DCAA to obtain data on Government-owned property and materials held by contractors that will assist USD(C) in developing policies for financial statement reporting. The DCAA evaluation included eight categories of Government-owned property and materials: other real property, other plant equipment, industrial plant equipment, special test equipment, special tooling, agency peculiar property (NDPPE), Government-furnished material, and contractor-acquired material. DCAA performed the evaluation at 36 contractor sites, including 3 commercial shipyards, and provided the results of the audit to USD(C) in September 2000. DCAA reported that contractor policies and procedures for accounting for Government-owned property and materials were inconsistent and that the policies and procedures lacked sufficient detail to ensure accurate financial reporting of the value or age of the items, or both.

Based on the USD(C) proposed change, the October 2000 version of DoD 7000.14-R, volume 6B, chapter 4, states that the CPMS database shall not be used for reporting the value of Government-owned materials held by contractors on DoD financial statements. In the October 2000 version of DoD 7000.14-R, volume 6B, chapter 10, the reporting entities are required to state that Government-furnished materials and contractor-acquired materials held by contractors are generally not included in OM&S values reported on the financial statements. The Inspector General, DoD, provided comments to the DoD 7000.14-R drafts in August and October 2000, stating that the reporting entities should use CPMS in lieu of reporting no value for Government-owned materials held by contractors. If the Navy follows the revised DoD 7000.14-R, the Navy will not be able to report values for Government-owned materials held by contractors because CPMS is the only method the Navy has in place for obtaining the data.



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**SFFAS Requirements.** The SFFAS No. 3 requires that the reliability of the data reported in the financial statements be disclosed in the footnotes. If the data used in the financial statements are unreliable, the footnotes should state that the values reported are unreliable and state whether the unreliable data have a material impact on the financial statements as a whole. To comply with the SFFAS, the Navy should use CPMS to report Government-owned materials held by contractors as part of OM&S in the FY 2000 financial statements and disclose that the values are not reliable. Therefore, USD(C) needs to rescind its form and content policy change and require the Military Departments to use CPMS to report Government-owned materials held by contractors on the financial statements, and disclose that the data is unreliable until the Military Departments develop reliable financial feeder systems. We made similar recommendations in our August 2000 comments to the draft of the DoD 7000.14-R, volume 6B, chapter 4, July 2000.

**DoD Policy on OM&S.** DoD 7000.14-R, volume 4, "Accounting Policy and Procedures," chapter 4, "Operating Materials and Supplies and Stockpile Materials," updated November 1999, was published to implement the requirements of the SFFAS No. 3 for DoD. However, DoD 7000.14-R does not agree with the SFFAS No. 8 because DoD 7000.14-R requires that expenses for the last 2 fiscal years be reported on the required supplemental stewardship information for NDPPE, while the SFFAS No. 8 requires the construction of NDPPE items to be tracked in a work-in-process account for financial statement reporting.

## Summary

The five commercial shipyards that we reviewed reported inaccurate financial values in CPMS for Government-owned materials furnished by the Navy or acquired by the contractors primarily because of incomplete financial information primarily provided by the Navy and maintained in contractor property records. In addition, commercial shipyard contractors reported inaccurate financial values in CPMS for Government-owned materials because of the lack of requirements to separately report materials on hand and issued to the end item (work in process), which is required for financial statement reporting. The Navy used this inaccurate financial data for Government-owned materials held by the contractors to support OM&S reported in its FY 1999 financial statements. As a result, the Navy disclaimed the appropriateness of the balance. Also, the Navy overstated the value of \$4.3 billion of Government-owned materials by at least \$1.4 billion for FY 1999. In FY 2000, the Navy did not report any value for Government-owned materials and will continue to report balances that should be disclaimed for OM&S.

DoD 7000.14-R, volume 6B, chapter 4, October 2000, states that the CPMS database shall not be used for reporting the value of Government-owned materials held by contractors on DoD financial statements, which is not in accordance with DoD financial statement reporting requirements, SFFAS Nos. 3 and 8. Because the values reported for Government-owned materials held by contractors cannot be relied upon, the values for Government-owned materials

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on hand should be disclosed as OM&S in the notes section to the financial statements until the Navy can provide auditable and reliable financial data.

## **Recommendations, Management Comments, and Audit Response**

**Revised, Deleted, and Renumbered Recommendations.** As a result of management comments, we revised draft Recommendations A.1. and A.2. to improve the reporting of Government-owned materials in the possession of contractors. We deleted Recommendations A.2.a. and A.2.b. Draft Recommendations A.1., A.2., B.1., and B.2. have been renumbered as Recommendations 1., 2., 3.a., and 3.b.

**1. We recommend the Under Secretary of Defense (Comptroller), revise the DoD Financial Management Regulation, DoD 7000.14-R, to comply with Statement of Federal Financial Accounting Standards that require Government-owned materials held by contractors to be reported as assets in the financial statements in accordance with Statement of Federal Financial Accounting Standard No. 3 and as acquisition-in-process in accordance with Statement of Federal Financial Accounting Standard No. 8.**

**Management Comments.** The Deputy Chief Financial Officer disagreed that Government-owned materials held by commercial shipyard contractors are part of operating materials and supplies, and should be reported in the financial statements. The Deputy stated that Statement of Federal Financial Accounting Standard No. 3, Paragraph 36, specifically excludes goods that were acquired for use in constructing real property or assembling equipment to be used by the entity. In addition, the Statement of Federal Financial Accounting Standard No. 3, Paragraph 39, states that operating materials and supplies are expensed when issued to an end user for consumption. Furthermore, Navy ships are National Defense property, plant, and equipment. Statement of Federal Financial Accounting Standard No. 6, Paragraphs 53 and 55, provide for National Defense property, plant, and equipment to be expensed rather than capitalized.

**Audit Response.** The Deputy Chief Financial Officer comments are inconsistent with the applicable standards. We agree that Navy ships are National Defense property, plant, and equipment. However, we do not agree that Government-owned materials held by commercial shipyard contractors are in the hands of the end user. We revised the recommendation to clarify that Government-owned material held by contractors should be accounted for as an asset in the financial statements and expensed in an acquisition-in-process account when issued by the contractor in the manufacturing of Navy ships. Although the Deputy Chief Financial Officer stated that Navy ships are National Defense property, plant, and equipment, the Deputy referred to a paragraph in Statement of Federal Financial Accounting Standard No. 3 that applied to real property and assembling equipment. We believe the Deputy Chief Financial Officer erroneously referred to this paragraph, since little, if any, of the

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Government-owned materials we reviewed were used in the construction of real property or assembled equipment. We request the Under Secretary of Defense (Comptroller) to reconsider its position on the reporting of Government-owned materials held by contractors and provide additional comments on the final report.

**2. We recommend that the Director, Defense Procurement, revise the Defense Federal Acquisition Regulation Supplement as soon as the updated DoD property accountability procedures are agreed upon.**

**Management Comments.** The Director, Defense Procurement, concurred with the intent of the recommendation. The Director stated that the Under Secretary of Defense (Acquisition, Technology and Logistics), in coordination with the Under Secretary of Defense (Comptroller), DoD, Office of the Inspector General, and the General Accounting Office is developing new property accountability procedures to improve financial reporting of Government-owned materials. These procedures will improve DoD financial reports, including Government-owned material in the possession of contractors. The Director offered to revise the Defense Federal Acquisition Regulation Supplement as soon as the new property accountability procedures are agreed upon. The Deputy Chief Financial Officer disagreed with this recommendation because the Deputy believes that Statement of Federal Financial Accounting Standard No. 3 does not require Government-owned material to be reported as an asset on the financial statements. Therefore, the Defense Federal Acquisition Regulation Supplement does not need to be revised.

**Audit Response.** Since the draft report was issued, the Property, Plant, and Equipment Program Management Office was established to address property accountability procedures. The Director agreed to revise the Defense Federal Acquisition Regulation Supplement after the new property accountability procedures are agreed upon. We revised Recommendation 2. to reflect this sequence of events. We deleted Draft Recommendations A.2.a. and A.2.b., because the Director agreed to revise the Defense Federal Acquisition Regulation Supplement. As stated in the response under Recommendation 1., we disagree with the Deputy Chief Financial Officer and recommend that the Defense Federal Acquisition Regulation Supplement be revised according to the response received from the Director, Defense Procurement.

**3. We recommend that the Commander, Naval Sea Systems Command:**

**a. Provide accurate cost data on material furnished from the Navy to the contractors in accordance with Government standards and regulations; and**

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**b. Continue working with the Operating Materials and Supplies Working Group to develop auditable and reliable financial accounting feeder systems, so values reported on the financial statements can be relied upon.**

**Management Comments.** The Navy did not comment on the recommendations. We request that the Navy provide comments in response to the final report.

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## Appendix A. Audit Process

### Scope

**Work Performed.** We reviewed the FY 1999 Navy financial statements and required supplementary stewardship information, which included \$34 billion of property in the possession of contractors. Additionally, we reviewed the methodology used by the Navy to report OM&S held by contractors on the Navy's financial statements for FY 1999. We reviewed the process used by the Navy to compile the information reported on the financial statements for OM&S held by contractors. At 3 of the 5 commercial shipyards we visited, we reviewed a judgmental sample of 13 contracts with Government-owned materials valued at \$2.9 billion. For each contract selected, we obtained and reviewed supporting documentation for the amounts of Government-owned materials held by contractors and reported on the DD Form 1662 as of September 30, 1999. With Navy personnel, we also discussed how the Navy plans to report Government-owned material in the FY 2000 financial statements.

**Limitation to Scope.** Our review of Government-owned materials was limited because the lack of available and reliable records at contractor facilities made a review of the age of materials held by contractors too time-consuming. In addition, we did not review the management control program as it related to the overall objectives because DCAA evaluated internal controls at five commercial shipyards.

**DoD-Wide Corporate Level Government Performance and Results Act Goals.** In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal, subordinate performance goal, and performance measure:

- **FY 2001 Corporate-Level Goal 2:** Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-2)**
- **FY 2001 Subordinate Performance Goal 2.5:** Improve DoD financial and information management. **(01-DoD-2.5)**
- **FY 2001 Performance Measure 2.5.2:** Achieve unqualified opinions on financial statements. **(01-DoD-2.5.2)**

**General Accounting Office High-Risk Area.** The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Financial Management high-risk area.

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## Methodology

**Use of Computer-Processed Data.** We relied on computer-processed data from the DoD CPMS to determine contracting activities to visit and to determine audit sample selection. We also relied on computer-processed data from the contractor computer systems that supported the dollar amounts reported on the DD Form 1662. Although we did not perform a formal reliability assessment of computer-processed data, the contracts reviewed and dollar amounts reported generally agreed with the information in the computer-processed data. We did not find errors that would preclude the use of the computer-processed data to meet the audit objectives or that would change the conclusions in this report.

**Audit Period and Standards.** We performed this financial-related audit from January through November 2000 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

**Contacts During the Audit.** We visited or contacted individuals and organizations within the DoD and within five commercial shipyards. Further details are available upon request.

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## Appendix B. Prior Coverage

The General Accounting Office and the Inspector General, DoD, have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at <http://www.gao.gov>. Unrestricted Inspector General, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil/audit/reports>.

### General Accounting Office

Report No. NSIAD 98-16 (OSD Case No. 1482), “Financial Reporting: DOD's Fiscal Year 1996 Financial Statements Inventory Reporting Does Not Meet Standards,” December 24, 1997

Report No. NSIAD-96-94 (OSD Case No. 1668), “Navy Financial Management: Improved Management of Operating Materials and Supplies Could Yield Significant Savings,” August 16, 1996

### Inspector General, DoD

Inspector General, DoD, Report No. D-2000-183, “Navy FY 1999 Financial Reporting of Operating Materials and Supplies – Ammunition,” September 1, 2000

Inspector General, DoD, Report No. 99-243, “Reliability of the Military Departments Real Property Databases for Existence and Completeness,” August 27, 1999

Inspector General, DoD, Report No. 99-032, “Reporting of DoD Inventory and Operating Materials and Supplies on the FY 1997 DoD Consolidated Financial Statements,” November 5, 1998

Inspector General, DoD, Report No. 99-013, “Summary Report on Financial Reporting of Government Property in the Custody of Contractors,” October 15, 1998

Inspector General, DoD, Report No. 98-042, “Financial Reporting by Selected Defense Agencies of Government Property in the Custody of Contractors,” December 16, 1997

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## Appendix C. Accounting Requirements for Operating Materials and Supplies

**Statements of Federal Financial Accounting Standards.** Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990, as amended, requires Federal organizations to develop and report cost information and to systematically measure performance. As a result of those requirements, the Federal Accounting Standards Advisory Board issued the SFFAS Nos. 3 and 8. According to the SFFAS Nos. 3 and 8, materials are reported as assets on the balance sheet when purchased (on hand and not issued) and are expensed when issued for consumption in the end item (work in process). Therefore, the cost of materials should be expensed once the materials are incorporated or attached to an end item. For costs incurred over a number of years, the portion of the costs incurred during the period is expensed and the total cost to date is recorded in a work-in-process account on the required supplemental stewardship report in the period used.

**Accounting for Material.** In the SFFAS No. 3, the Federal Accounting Standards Advisory Board issued accounting principles for OM&S. OM&S is reported as an asset on the balance sheet and is defined as tangible personal property to be consumed in normal operations. SFFAS No. 3 requires OM&S to be categorized as the following:

- OM&S held for use;
- OM&S held for future use; and
- OM&S excess, obsolete, and unserviceable.

Government-owned materials held by contractors meet the criteria and are to be reported as OM&S.

**Accounting Method for OM&S.** The consumption method of accounting is used for recognition of expenses for OM&S. The consumption method is an assumption as to when to recognize an expense, in the sense that the eventual use (consumption) results in the recognition in the expenditure account. Under the consumption method, the acquisition of OM&S is viewed as the conversion of resources (from cash to OM&S), and not the use of resources. Therefore, the entity still has resources to use. Another method for recognizing OM&S is the purchase method. Under the purchase method, the acquisition of OM&S is considered to be the use of resources. Therefore, the entity has used up its resources, or expended them.

**Valuation Method for OM&S.** SFFAS No. 3 requires OM&S to be valued on the basis of historical cost. Historical cost includes all appropriate purchase and production costs that are incurred to bring the items to their current condition and location. SFFAS No. 3 states that the first-in/first-out,



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weighted average, or moving average cost flow assumptions, are the preferred methods for arriving at historical cost. However, other reasonable valuation methods could be used if the results reasonably approximated the historical cost methods (for example, a standard cost or latest acquisition cost system).

**Accounting for National Defense Assets.** SFFAS No. 8 provides guidance pertaining to the information required to be reported on the supplementary stewardship report. SFFAS No. 8 states that the acquisition cost of National Defense Property, Plant, and Equipment (NDPPE) is considered an expense in the period acquired. The cost of material used in construction, improvement, reconstruction, or renovation of NDPPE is expensed in the period incurred.

**DoD Financial Management Regulation.** DoD 7000.14-R states how material and NDPPE should be accounted for in the DoD financial statements. DoD 7000.14-R, volume 4, chapter 4, "Operating Materials and Supplies and Stockpile Materials," describes OM&S as the amount of tangible personal property consumed in normal operations. DoD 7000.14-R, volume 6B, chapter 11, "Required Supplementary Stewardship Information Reporting," requires Military Departments to disclose Supplementary Stewardship Report information pertaining to their National Defense Assets. DoD 7000.14-R requires OM&S to be categorized as OM&S held for use, OM&S held for future use, or excess, obsolete and unserviceable OM&S.

**Accounting for Material.** DoD 7000.14-R states that the consumption method of accounting for recognition of expenses is ordinarily applied for OM&S. The consumption method requires OM&S to be recognized as assets when purchased and the cost of those OM&S to be expensed in the period they are issued for consumption in normal operations. The consumption method is based on historical cost, which includes all costs incurred to bring the item to its current condition and location.

**Accounting for National Defense Assets.** NDPPE consists of weapon systems; components of weapons; mission support property, plant, and equipment; and weapon systems support real property used by DoD or its Components in performance of military missions. The DoD Components are required to report the quantities of National Defense Assets for which they are accountable as well as their annual outlays for all National Defense Assets.

**FMR Disclosure Requirements.** DoD 7000.14-R disclosure requirements for OM&S on the DoD financial statements include the general composition of the material, the account balances for each category of material, the basis for determining the values of OM&S, and the decision criteria for assigning OM&S to the appropriate categories.

## Appendix D. Pricing Data for Government-Owned Materials Furnished to Five Commercial Shipyards

**Pricing for Government-Owned Furnished Material at Supervisor of Shipbuilding, Conversion and Repair (SUPSHIP) Pascagoula.** At SUPSHIP Pascagoula, Mississippi, 3 contracts contained 2,598 items of Government-owned materials furnished to the contractor and received as of October 6, 1999. Of the 2,598 items received, 1,746 items (67 percent) were valued at \$162.9 million, based on individual or system prices provided to the contractor. Because the actual dollar amount reported on the DD Form 1662 for the items was \$1.5 billion, the DD Form 1662 is potentially overstated by \$1.4 billion. However, the dollar value of the remaining 852 items (33 percent) that were received without an individual price or system price could reduce the overstatement by an undeterminable amount. The following table provides an example of system prices for Government-owned materials furnished to the contractor and reported on the DD Form 1662 compared with the actual price of items received for seven hulls under contracts administered by SUPSHIP Pascagoula.

<b>Navy Cost Data For Government-Owned Materials Furnished to the Contractor</b>			
<u>Hull</u>	<u>Government-Owned Material Amounts</u>		<u>Difference</u>
	<u>Reported</u>	<u>Received</u>	
LHD 7	\$ 117,901,049	\$ 43,742,847	\$ 74,158,202
DDG 80	412,404,367	71,966,179	340,438,188
DDG 82	414,013,061	27,905,192	386,107,869
DDG 84	370,861,229	10,991,529	359,869,700
DDG 86	208,313,217	5,012,566	203,300,651
DDG 88	9,287,806	3,247,584	6,040,222
<b>Total</b>	<b>\$1,532,780,729</b>	<b>\$162,865,897</b>	<b>\$1,369,914,832</b>

In addition, DCAA reviewed the 20 items of material acquired by the contractor and found that none of the 20 items included freight and discount, General and Administrative burdens, or Material Acquisition Planning burdens. However, DCAA did not quantify the effect the pricing errors would have on the values reported in CPMS and the Navy financial statements. The DoD Inspector General audit team performed additional calculations on the pricing data provided by DCAA for the sample of 20 items, which identified a net increase of 11 percent for the cost of the 20 items, or \$31,640.

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**Pricing for Government-Owned Furnished Material at SUPSHIP Newport News.** Four contracts reviewed at SUPSHIP Newport News, Virginia, included 3,141 items of Government-owned materials furnished by the Navy to the contractor. Of the 3,141 items received under the 4 contracts, 1,848 items were valued at \$27,738,667 and 1,297 items (41 percent) did not have price information on the physical inventory lists. Therefore, the financial statements were potentially understated by the undeterminable value of the 1,297 items.

From these 4 contracts, we judgmentally sampled 34 items: 23 with a dollar value assigned and 11 with a dollar value of \$0. The 34 items were traced to the receiving reports to verify the prices. The majority of the receiving reports either included one price for all the items on the receiving report or did not contain any prices. Both situations cause the contractor to have to figure out prices for individual items. For receiving reports that only contained one price for a whole list of items, contractor personnel (by direction from SUPSHIP Newport News) assigned the price to the first item on the list and assigned \$0 as the price for each of the remaining items. For receiving reports that contained no price information, contractor personnel also assign a dollar value of \$0 to each of the items. Therefore, the contractor had no supporting documentation for the dollar value assigned to these items. As a result, 10 of the 11 items valued at \$0 on the DD Form 1662 also had a value of \$0 on the receiving reports. In addition, 10 of the remaining 24 items had discrepancies in the dollar value reported on the receiving reports in contrast to the dollar value reported on the DD Form 1662, which resulted in a net overstatement of \$4.5 million.

The review of three contracts at SUPSHIP Newport News identified additional Government-owned materials that did not previously have a dollar value assigned. The dollar amounts for Government-owned materials furnished to the contractor on all three contracts increased from FY 1998 to FY 1999 because the contracts had excess Government-owned materials that needed pricing data before SUPSHIP Newport News could dispose of the materials. The increase in dollar amounts for Government-owned materials was \$18.5 million, which means that the FY 1998 DD Form 1662 and financial statements were potentially understated by \$18.5 million.

For each of the four sample contracts, we obtained database printouts dated October 1, 1999, which provided the dollar amounts for the portion of materials furnished by the Government and consumed during ship construction. Most of the contracts had a “physical inventory” printout and a “running total” printout. We reviewed the two printouts for each contract and identified any differences. The “running total” printout for one contract was \$13.2 million, but the physical inventory for materials furnished by the Government was only \$6.3 million. The difference of \$6.9 million represents the dollar value of materials furnished by the Government that had been issued to the ship and should have been accounted for in a work-in-process account instead of being included on the DD Form 1662. Therefore, the DD Form 1662 and financial statements were overstated by \$6.9 million.

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DCAA determined that the materials acquired by the contractor for the Government are reported in the CPMS database at the average purchase order price and no associated overhead, general and administrative costs, or fee was applied, but was unable to quantify the amount that materials acquired by the contractor was understated. However, DCAA determined that the value of materials acquired by the contractor reported in the CPMS database included both material on-hand and work-in-process balances, but the contractor was able to separate materials acquired for the Government into material on-hand and issued material (work in process). Because the \$20.1 million of issued material should have been expensed and reported in a work-in-process account, the CPMS database was potentially overstated by \$20.1 million.

**Pricing for Government-Owned Furnished Material at SUPSHIP Groton.**

At SUPSHIP Groton, Connecticut, 1 contract contained 69 systems on the Government-owned materials price list provided by the Navy and all 69 systems had a price assigned. On April 5, 2000, 7 of the 69 systems were judgmentally selected to determine whether all components making up the systems had been received. Only 9,068 of the 30,845 components for the 7 systems had been received as of April 5, 2000. Additionally, 1,442 of the components received had already been issued to the ship. Based on an agreement between the Navy and contractor personnel, the contractor reported \$83,815,974 on the financial statement for these seven items. However, only \$20,723,834 should have been reported in CPMS as Government-owned materials. In addition, \$3,918,061 of the resulting \$63,092,140 overstatement should have been transferred to a work-in-process account.

DCAA reviewed contractor pricing data for four contracts with Government-owned materials acquired by the contractor that the audit team had judgmentally selected. DCAA identified internal control weaknesses in the policies, procedures, and pricing techniques used for reporting materials acquired by the contractor in the CPMS database. For two contracts, DCAA determined that \$5 million was reported in the CPMS database as materials acquired by the contractor that were actually materials furnished by the Government. The misclassification of materials would not affect the Navy financial statements because both types of Government-owned materials are reported as OM&S on the balance sheet. However, DCAA also determined that the contractor might have potentially understated materials acquired by the contractor on one contract by \$2.7 million because of omissions, which would result in the Navy financial statements being understated.

**Pricing for Government-Owned Furnished Material at SUPSHIP San Diego.**

DCAA performed the audit work at SUPSHIP San Diego, California. Out of 5,961 items of Government-owned materials furnished to the contractor, DCAA took a sample of 31 items to validate the contractor's pricing data. DCAA was able to verify the values reported on the DD Form 1662 for 23 of the 31 items. One of the remaining eight items represented the dollar value for two ship sets of class standard equipment; however, the component parts that make up the class standard equipment were listed at zero dollar value. In addition, the remaining seven items were reported at zero dollar value and the contractor had no supporting documentation to establish values for these items. DCAA also

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reviewed contractor pricing data for 30 items of material acquired by the contractor. DCAA validated the pricing data for 29 of the 30 items; the remaining item was a component part reported at zero value and the contractor did not have supporting documentation to establish a value. DCAA determined that the contractor used purchase order prices for reporting materials acquired by the contractor in the CPMS database. The prices did not include indirect expenses or fees, which would have been calculated at eight percent in FY 1999. As a result, the \$1,306,078 of materials acquired by the contractor and reported in CPMS as of September 30, 1999, was understated by \$104,486. Therefore, the financial statements were understated by the same amount.

**Pricing for Government-Owned Furnished Material at SUPSHIP Bath.**

DCAA performed the audit work at SUPSHIP Bath, Maine. Out of \$1.1 billion worth of Government-owned materials furnished to the contractor, DCAA took a sample of 29 items worth \$40 million to validate the contractor's pricing data. DCAA was able to verify the values reported on the DD Form 1662 for all 29 items. In addition, DCAA reviewed contractor pricing data for 21 items of materials acquired by the contractor. Of the 21 sampled items, DCAA determined that 10 items were correctly valued; 3 items were incorrectly valued; 5 items were misclassified (should have been reported as materials furnished by the Government [3] and special tooling [2]); and 3 items were priced at the "Government reference price" instead of the contractor's actual price.

- Two of the three items incorrectly valued resulted in an overstatement of \$971,398 because the contractor doubled their price; each item cost \$485,699, but the contractor reported each item at \$971,398.
- For the five misclassified items, materials acquired by the contractor were overstated by the value of the five items; materials furnished by the Government and special tooling were understated by the same amount. Therefore, the net effect would be zero.
- The three items priced at the "Government reference price" were understated by \$8,456 because the contractor did not use the purchase price.

In addition, DCAA identified an understatement on the DD Form 1662 of approximately \$20 million of material items acquired by the contractor located at subcontractor locations and not reported by the contractor. As a result, the Navy financial statements are potentially understated by approximately \$20 million and overstated by approximately \$1 million.

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## **Appendix E. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense (Acquisition, Technology and Logistics)  
Under Secretary of Defense (Comptroller)  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)  
Deputy Under Secretary of Defense (Acquisition Reform)  
Director, Defense Procurement

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Assistant Secretary of the Navy (Manpower and Reserve Affairs)  
Naval Inspector General  
Auditor General, Department of the Navy  
Commander, Naval Sea Systems Command

### **Department of the Air Force**

Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Auditor General, Department of the Air Force

### **Non-Defense Federal Organization**

Office of Management and Budget

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## **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Government Reform  
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations  
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform  
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform





# Under Secretary of Defense (Comptroller) Comments



OFFICE OF THE UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100

FEB 2 2001

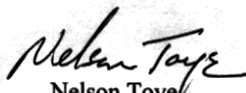
## MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Response to the Office of the Inspector General, Department of Defense (OIG, DoD) Draft Audit Report, "Navy Financial Reporting of Government Materials Held By Commercial Shipyard Contractors," dated November 29, 2000 (Project Number D2000FA-0094)

This is in response to recommendations A1 and A2 of the subject draft report.

This office disagrees with the recommendations directed to the USD(C) and to the underlying interpretation of Statement of Federal Financial Accounting Standard (SFFAS) No. 3 upon which the recommendations are based. The draft report contends that government-owned materials held by commercial shipyards meet the criteria to be reported as operating materials and supplies (OM&S). The OIG, DoD appears to have chosen to cite parts of the SFFAS No. 3 while ignoring and failing to include in its draft report other parts of the SFFAS No. 3 with which the OIG appears to disagree. Nevertheless, in defining OM&S, SFFAS No. 3, in the last sentence of paragraph 36, specifically states: "Excluded are (1) goods that have been acquired for use in constructing real property or assembling equipment to be used by the entity....". This exclusion appears to apply to government-owned material at commercial shipyards producing Navy ships. Furthermore, Navy ships are National Defense property, plant and equipment (PP&E). Because SFFAS # 6, paragraphs 53 and 55, provides for National Defense PP&E to be expensed rather than capitalized, it would appear to be proper to expense materials that are to be incorporated into Navy ships. Materials expensed should not also be reported on the financial statements as assets.

My point of contact for this matter is Dr. Fred Wulsin. He may be reached by e-mail: [wulsinf@osd.pentagon.mil](mailto:wulsinf@osd.pentagon.mil) or by telephone at (703) 697-3135.

  
Nelson Toyer  
Deputy Chief Financial Officer

Attachment

Revised and  
Renumbered  
as Recommendation 1.

Revised and  
Renumbered  
as Recommendation 2.

OFFICE OF THE INSPECTOR GENERAL DRAFT AUDIT REPORT

“NAVY FINANCIAL REPORTING OF GOVERNMENT MATERIALS  
HELD BY COMMERCIAL SHIPYARD CONTRACTORS”  
DATED NOVEMBER 29, 2000  
(PROJECT NO. D2000FA-0094)

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COMMENTS ON RECOMMENDATIONS

**OIG, DoD Recommendation A1:** We recommend the Under Secretary of Defense (Comptroller) (USD(C)) revise the Department of Defense Financial Management Regulation, Department of Defense (DoD) 7000.14-R, Volume 6B, Chapter 4, October 2000, to state that government-owned materials held by contractors that are part of operating materials and supplies (OM&S) should be reported in the financial statements and disclosed as unreliable until the Military Departments develop auditable and reliable accounting feeder systems.

**DoD Response:** The Department disagrees with the OIG, DoD’s interpretation that the material addressed in this report constitutes OM&S. This office does not believe that government-owned materials held by commercial shipyard contractors are part of OM&S and should be reported in the financial statements. The Statement of Federal Financial Accounting Standards (SFFAS) No. 3, paragraph 36, specifically excludes “goods that have been acquired for use in constructing real property or assembling equipment to be used by the entity” from the definition of OM&S. This exclusion would appear to apply to Government Furnished Material (GFM) and Contractor Acquired Material (CAM) at commercial shipyards constructing Navy ships. Furthermore, Navy ships are National Defense property, plant and equipment (PP&E). The SFFAS # 6, paragraphs 53 and 55, provides for National Defense PP&E to be expensed rather than capitalized. Accordingly, it would appear to be proper to expense materials to be incorporated into Navy ships. Materials that are expensed should not also be reported on the financial statements as assets.

Other GFM and CAM at commercial shipyards may be used to repair Navy ships rather than to build or modify them. Items used in the repair process also are expensed (“consumed”) rather than capitalized. According to the SFFAS No. 3, paragraph 39, OM&S is expensed when issued to an end user for consumption in normal operations. The Department considers the commercial shipyard to be the end user.

**OIG, DoD Recommendation A2:** We recommend the USD(C) should request the Director, Defense Procurement to revise the Defense Federal Acquisition Regulation Supplement to: (a) require contractors to report the value of government-owned materials in their possession in the Contract Property Management System database by the categories established in the SFFAS No. 3, and (b) require contractors to separately report the value of government-owned materials on hand from the value of materials issued to work-in-process.

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**DoD Response:** As discussed in the response to recommendation A1 above, this office believes that SFFAS No. 3 does not require reporting, as an asset, the value of government-owned materials held by commercial shipyard contractors.

# Under Secretary of Defense (Acquisition, Technology and Logistics) Comments



ACQUISITION AND  
TECHNOLOGY

## OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON  
WASHINGTON DC 20301-3000

JANUARY 17, 2001

DP/MPI

MEMORANDUM FOR THE INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

THROUGH: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS *1/24/01*

SUBJECT: Draft Audit Report entitled "Navy Financial Reporting of Government Materials Held by Commercial Shipyard Contractors," Project No. D2000FA-0094, November 29, 2000

Generally, I concur with the draft report's intent. The USD(AT&L), in coordination with the USD(C), the DoDIG, and the GAO, is developing new property accountability procedures that will improve DoD financial reports, including government-owned material in the possession of contractors. It appears premature, however, to change the DFARS until the new DoD property accountability guidance is in place. Therefore, I suggest modifying the recommendations addressed to me as shown on the attachment to this memorandum.

I appreciate the opportunity to comment on the draft report.

Deidre A. Lee  
Director, Defense Procurement

Attachment:  
As stated



**DRAFT AUDIT REPORT ON NAVY FINANCIAL REPORTING  
OF GOVERNMENT MATERIALS HELD BY COMMERCIAL SHIPYARD CONTRACTORS  
(PROJECT NO. D2000FA-0094), NOVEMBER 29, 2000**

**DEPARTMENT OF DEFENSE COMMENTS**

**EXECUTIVE SUMMARY RECOMMENDATION:**

"We also recommend that the Director, Defense Procurement, revise the Defense Federal Acquisition Regulation Supplement to require that contractors provide more detailed property records so that DoD can prepare more accurate financial statements."

**DDP RESPONSE:**

Suggest the following revision: "We also recommend that the Director, Defense Procurement, revise the Defense Federal Acquisition Regulation Supplement **as soon as the revised DoD property accountability procedures are agreed upon.** ~~to require that contractors provide more detailed property records so that DoD can prepare more accurate financial statements"~~

**RECOMMENDATION A.2.:**

"Request the Director, Defense Procurement, revise the Defense Federal Acquisition Regulation Supplement to:

a. Require contractors to report the value of Government-owned materials in their possession in the CPMS database by categories established in the Statement of Federal Financial Accounting Standards No. 3; and

b. Require contractors to separately report the value of Government-owned materials on hand from the value of materials issued to work in process."

**DDP RESPONSE:**

Suggest the following revision:

"Request the Director, Defense Procurement, revise the Defense Federal Acquisition Regulation Supplement **to as soon as the revised DoD property accountability procedures are agreed upon.**

~~a. Require contractors to report the value of Government-owned materials in their possession in the CPMS database by categories established in the Statement of Federal Financial Accounting Standards No. 3; and~~

~~b. Require contractors to separately report the value of Government-owned materials on hand from the value of materials issued to work in process."~~

ATTACHMENT

Revised and  
Renumbered  
as Recommendation 2.

Deleted

Deleted

## **Audit Team Members**

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